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A New Concept of Fraud on the Securities Exchange--A Comment on In Re Cady Roberts & Co.

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CASE COMMENTS

A NEW CONCEPT OF FRAUD ON THE SECURITIES EXCHANGE — A COMMENT ON IN RE CADY ROBERTS & CO.

Respondent broker, a member of a registered brokerage firm, received information regarding a stock dividend reduction from a director of the Curtis-Wright corporation who was also an associate of the brokerage firm. Unknown to the director there had been a telegraphic delay in transmitting the action of the board of directors to the exchange so that at the time of his conversation with respondent the information had not yet been made public. Knowing the information had not yet reached the exchange and without disclosing the dividend action, respondent executed two sell orders for discretionary accounts — one for 2,000 shares for ten accounts and the other to sell short 5,000 shares for eleven accounts. Two days prior to the dividend meeting respondent had disposed of 6,500 shares, 4,300 of which had been sold on the date in question but prior to the time of the conversation between respondent and the director. The orders were executed approximately one-half hour before the announcement of the dividend reduction appeared on the ticker. *In re Cady Roberts Co.*, SEC Securities Act Release No. 6668, November 8, 1961.

In a proceeding brought under the authority of Section 19(a)(3) of the Securities Exchange Act,[1] the Commission held that respondent's conduct was a willful violation of the anti-fraud provisions of the Securities Exchange Act[2] and that it was in the public interest to suspend respondent from the exchange for 20 days.[3] The Commission held that receipt

1. 48 Stat. 898 (1934), 15 U. S. C. §78s(a)(3) (1960).
2. Securities Act of 1933 §17(a), 48 Stat. 84 (1933), 15 U. S. C. §77q(a) (1958); Securities Exchange Act of 1934 §10(b), 48 Stat. 891 (1934), 15 U. S. C. §78j(b) (1958); SEC Rule 10b-5, 17 C. F. R. §240.10b-5 (1949).
3. Under §19(a)(3) the remedies available to the Commission were imposition of a fine and/or suspension from the exchange. In the instant case respondents submitted an offer for settlement whereby the facts stipulated were agreed to constitute the record for the purpose of determining the occurrence of a willful violation of the designated anti-fraud provisions and the entering of an appropriate order, on the condition that no sanction be entered in excess of a suspension of the broker, Gintel, for twenty days from the New York Stock Exchange. The offer of settlement was submitted pursuant to §5(b) of the Administrative Procedure Act and Rule 8 of the Rules of Practice of the Securities Exchange Commission.

of non-public information imposes an affirmative duty to disclose analagous to that of a corporate insider who acquires knowledge by virtue of his position and that this duty extends both to transactions on an exchange as well as face-to-face dealings. The obligation to disclose stems from possession of non-public information and the inherent unfairness involved where one party takes advantage of such information knowing it is unavailable to those with whom he is dealing. The Commission further held that the duty was two-fold: either to disclose or, in the alternative, if disclosure were not possible or practical, to refrain from dealing until the information had been made available to the public. Use of such information by one with insider disclosure duties is a deceptive practice or course of business amounting to a fraud within the meaning of Rule 10b-5(3) promulgated under Section 10(b) of the Securities Exchange Act of 1934.[4]

One of the fundamental characteristics of a free securities market is its sensitivity to the diverse factors which influence investors' evaluation of their future interests and future price movements.[5] Changes in the economic climate both here and abroad, changes in the political or economic relations with other countries, new discoveries, sudden increases in product popularity, and many other factors can substantially affect security prices in a very brief period of time. This inherent instability is at once both the virtue of the field because of the possibility of great profits and its defect because of the increased opportunity and temptation for abuse.[6] Because security investment is essential to a healthy economy, there has long been great concern to insure a fair and honest market which reflects an evaluation of securities in the light of all available and pertinent data. The means toward this end has been to eliminate as much as possible the abuses which arise from unfair practices by those who deal in the securities market. The courts and Congress

4. *In re* Cady Roberts & Co., SEC Securities Act Release No. 6668, November 8, 1961.

5. "The entire field of securities transaction is to some degree speculative in nature, and sales are usually motivated by a difference in opinion between vendor and purchaser regarding the future prospects of the particular security involved." Mills v. Sarjem Corp., 133 F. Supp. 753, 764 (D. N. J. 1955).

6. "The business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision and action." Archer v. SEC, 133 F. 2d 795, 803 (8th Cir. 1943), *cert. denied,* 319 U. S. 767, 87 L. Ed. 1711 (1943).

seek to protect those who do not know market conditions from the overreachings of those who do[7] by holding insiders to the highest standards of honesty and fair play.[8] "Intimacy demands restraint lest the uninformed be exploited."[9]

The development of the common law in this area was slow and was greatly hampered by the many technicalities of the common law actions. Strained constructions and fictional exceptions were employed by the courts to provide remedies for the most flagrant abuses, but this led to great diversity of interpretation and application of the common law rules from state to state. Judicial remedy was neither uniform nor certain; general regulation was beyond the authority of the courts. The principal stains on the integrity of the market were those market practices which were unfair but were short of actual common law fraud. These practices were beyond the pale of the words. Recognizing the need for national legislation in this area, Congress in 1933 and again in 1934 enacted laws to extend the right of private action to more of those who are injured by insider abuses. The principal thrust of the laws, however, is aimed at regulation of the practices which injure, thus cutting down the need for private remedy by striking directly at the source of the abuse.

Based on the underlying theme of full and fair disclosure,[10] the Congressional attack is two-pronged: (1) statutory language broad enough to avoid the limitation of strict substantive rules which had plagued the common law courts, (2) an administrative agency with police and supervisory authority to construe and enforce the Act. In order to maintain fair and open markets for the buying and selling of securities and to prevent abuse of the facilities provided by the exchanges, the Act imposes regulatory control in the form of disclosure requirements upon the national securities

7. Charles Hughes & Co. v. SEC, 139 F. 2d 434 (2d Cir. 1943).
8. "The best element of business has long since decided that honesty should govern competitive enterprises and that the rule of caveat emptor should not be relied on to reward fraud and deception." Federal Trade Com'n v. Standard Educ. Soc'y, 302 U. S. 112, 116, 82 L. Ed. 141, 145 (1937).
9. *In re* Cady Roberts & Co., SEC Securities Exchange Act Release No. 6668, November 8, 1961, 34-6668.
10. This use of disclosure to promote the integrity of the securities market is considered by Loss to be an embodiment of the concept that the Truth shall make you free. 1 LOSS, SECURITIES REGULATIONS 21 (2d ed. 1961).

exchanges, upon the practices employed in trading in securities, and upon dealers and brokers.[11]

The traditional dichotomy between legal standards and ethical standards is thus minimized. Congress authorized the Commission to set up legal standards through the promulgation of rules which are to be applied in the light of the ethical considerations of honesty and fairness. Congress thus established a system whereby both the letter and the spirit of the act might be administered concurrently. The spirit is that of promoting the highest ethics in securities transaction by requiring full and complete disclosure. The letter is that of the rules promulgated by the Commission. In effect, Congress has made it possible for the Commission to engraft a body of federal common law on the structure of Sections 10(b), 17(a), and Rule 10b-5. From the beginning the courts and the Commission recognized the fact that Section 10(b) and Rule 10b-5 allowed them to reach results more in line with obligations of fairness than the common law permitted, however, they were reluctant to abandon all common law restrictions and to administer the act on the principles of good business ethics alone.[12]

In *Cady Roberts* the Commission administered the act entirely on the basis of the ethical considerations Congress intended. The conduct of the respondent, though not amounting to common law fraud, was unethical and unfair. Under Rule 10b-5 as interpreted by the Commission, such conduct amounted to a fraud. The effect of the case is to say that the possession of information, the use of which by a director, officer, or ten per cent majority shareholder would be an abuse of his position, imposes on the recipient an affirmative

11. "Disclosure is the foundation of reliance on self-regulatory approaches and is the clearest alternative to greater governmental or institutional intervention." Cary, *Corporate Standards and Legal Ethics*, 50 CALIF. L. REV. 408, 409 (1962).

12. Congress intended that a federal right, uniform in its nature, should be uniformly enforceable pursuant to federal standards, thus enabling the courts to avoid the entanglements and limitations of the common law. McClure v. Borne Chem. Co., Inc., 292 F. 2d 824 (2d Cir. 1961), upheld the spirit of the Act by refusing to apply common law concepts where it disrupted the Congressional intent even though the Act was silent on the particular point in question. This decision furthered the establishment of a body of federal corporate law which is distinct from the common law. Where a federal right is being enforced and Congress is silent, state law will control, but only where state law does not cut across federal intent receiving expression in the federal right sought to be enforced. Because the federal statute itself gives the federal court jurisdiction, the federal law and the federal intent must receive primary consideration.

duty of disclosure to unsolicited purchasers on the exchange. If such disclosure is inexpedient or is in itself a breach of some duty, the alternative disclosure duty is to wait until the inside information has been made public before dealing in order that such purchasers might have as full an opportunity as possible to be cognizant of the risk of the security itself. The Commission held that the status of insider and the corresponding duty to disclose under the Rule are both created and defined by the mere possession of inside information regardless of the relationship that the recipient has with the corporation. While the trend of the law has been a gradual ascent toward higher standards based on ethical considerations, *Cady Roberts* marks the highest point thus far in using the theory of complete disclosure as the principle to eliminate the dichotomy between legal rules and ethical standards.

Under the common law one party to a business transaction is protected only from the material misrepresentations and misleading half truths of the other party on which he has relied to his detriment. There is no remedy for damage resulting from the other party's silence about material facts unless there is an affirmative duty to disclose which duty arises only where there is a fiduciary or other relationship of trust and confidence between the parties.[13] Prior to 1934 the majority of courts found no fiduciary relationship between officers or directors and their stockholders. The mere failure on the part of such insider to disclose any facts pertaining to corporate affairs and affecting the value of the stock, which were within his knowledge but unknown to the shareholder, did not give rise to an action against him as long as he did not actively mislead the shareholder or make any false misrepresentations.[14] In the absence of actual fraudulent misrepresentation an employee could buy and sell securities of his corporation as a stranger even though he had inside information concerning the increased value of the stock.[15] The mere fact of being an insider with knowledge unavailable to the other party to the transaction did not of itself give rise to anything from which fraud or unfair dealing might

13. 3 RESTATEMENT, TORTS §529, 551 (1938): PROSSER, TORTS. 534 (2d ed. 1955); 3 LOSS, SECURITIES REGULATIONS 1434 (2d. ed. 1961); Note, *Civil Liability Under Rule X-10b-5*, 42 VA. L. REV. 537 (1956).
14. Carpenter v. Danforth, 52 Barb. 581 (N. Y. 1868). See generally, Annot., 84 A. L. R. 615 (1933).
15. Stout v. Cunningham, 33 Idaho 464, 196 Pac. 208 (1921); Woodruff v. Cole, 307 Mo. 19, 269 S. W. 599 (1925).

be inferred.[16] The minority view was that a director or officer seeking to purchase shares from a shareholder had a duty to disclose to the shareholder facts which had come to him by virtue of his relation to the company and were not known to the shareholder or which might not be readily ascertainable by the shareholder. This duty was held to be a fiduciary duty, but courts were reluctant to impose a duty as strict as that of a trustee.[17] In *Hotchkiss v. Fischer*[18] the court said that purchases by a director of corporate shares must be closely scrutinized to be sure that they are conducted with the utmost fairness. The duty to disclose was limited to those facts which were within the exclusive knowledge of the insider and which the shareholder by exercise of due diligence could not ascertain.[19] A middle of the road view ad-

16. One early case, Deadrick v. Wilson, 8 Boxt 108 (Tenn. 1874) not only held there was no fiduciary relationship and therefore no liability but said that officers were justified in availing themselves of a superior knowledge gained in their official capacity. Section 16 of the Act remedies this situation. It is designed to deprive corporate insiders of any incentive to abuse their position by trading in securities of their corporaton on the basis of information not known to the public. See generally, LATTIN, CORPORATIONS 264-266 (1959); Cole, *Insider's Liabilities Under the Securities Exchange Act of 1934*, 12 SW. L. J. 147 (1958); Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities Under Sec. 16(b)*, 45 VA. L. REV. 949, 979 (1959); Yourd, *Trading in Securities by Directors, Officers and Stockholders; Section 16 of The Securities Exchange Act*, 38 MICH. L. REV. 133 (1939); Note, 73 HARV. L. REV. 1635 (1960); Note, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947).

17. Oliver v. Oliver, 118 Ga. 362, 45 S. E. 232 (1903). To say that a director who has been placed where he himself may raise or depress the value of stock "or in a position where he fisrt knows of facts which may produce that result, may take advantage thereof, and buy from or sell to one whom he is directly representing, without making a full disclosure and putting the stockholder on an equality of knowledge as to these facts, would offer a premium for faithless silence, and give a reward for the suppression of truth. It would sanction concealment by one who is bound to speak, and permit him to take advantage of his own wrong, — a thing abhorrent to a court of conscience. " If a director is in possession of information which his duty to the company requires him to keep secret, he may not disclose this to a shareholder since his obligation to the company overrides that to an individual holder of the stock. The very fact that he cannot disclose the information prevents him from dealing with one who does not know the facts and to whom material information cannot be made known. This case was perhaps the forerunner of the alternative duty to disclose as set out by the Commission in *Cady Roberts*. *But see, In re* William I. Hay, 19 S. E. C. 397 (1945) (Duty to customers prevails over duty to the corporation).

18. 136 Kan. 530, 16 P. 2d 531 (1932).

19. The two extremes of this view are represented by Stark v. Soule, 27 N. Y. Week Dig. 80, 9 N. Y. S. R. 555 (1887) where it was held that since a director had superior means of knowledge, slight circumstances which had the effect of misleading the shareholder might afford occasion for redress, and by Boulder v. Stillwell, 100 Md. 543, 60 Atl. 609 (1905) where parties to a sale were all officers of the corporation the court held since by reason of their position they had equal means of knowing the

hered to the "special circumstances" doctrine first set out in *Strong v. Repide.*[20] Under this rule there might be circumstances of a nature which rendered the insider's conduct or failure to make full disclosure fraudulent in law (apart from the special relationship of the parties) even though a case of actionable fraud and deceit might not be made out.[21] The "special circumstance" rule neither supports nor repudiates the theory that a corporate insider has no fiduciary relation with shareholders from whom he purchases stock of his corporation and that to constitute fraud there must be actual misrepresentation. The rule merely imposes a duty to disclose in particular situations where a corporate insider has access to information such as merger, assured sale, or other facts enhancing or reducing the value of stock known by insiders, not known by shareholders, and not to be ascertained by an inspection of the books.[22] Thus, under the common law an action would not lie for silence or mere passive non-disclosure unless a fiduciary or other confidential relationship could be found. Some courts required disclosure where the defendant had special knowledge unavailable to the plaintiff and fair conduct demanded disclosure. But even where there was a duty to disclose, the requirement was only that a reasonable effort be made regardless of whether the information reached the other party.[23] Liability did not extend to protect buyers

financial condition of the corporation and its future prospects, the false statements by one relating to such matters could not be fraudulent and did not of themselves constitute a false representation as to an existing fact as would sustain an action for deceit.

20. 213 U. S. 419, 53 L. Ed. 853 (1909). See BALLENTINE, CORPORATIONS 213 (rev. ed. 1946); FLETCHER, CYC. CORP. §1167-71 (repl. 1947).

21. BALLENTINE, CORPORATIONS 213 (rev. ed. 1946).

22. The essence of the special facts doctrine is that a director or officer stands in a special relation to a shareholder because of his superior knowledge or means of information which relation, though not as strict as that of a trustee, gives the shareholder justification for reliance on statements of a director or officer which reliance would not be justified if the statements were made by a stranger. Thus, notwithstanding the fact that there is no fiduciary relation between officers and directors and shareholders as regards the purchase of stock in the corporation, the relationship is a circumstance which may enter into the question of actionable fraud or deceit.

23. RESTATEMENT, TORTS §551. Even under the Securities Exchange Acts the tendency is to hold that due diligence to make information publically available is all that is necessary to relieve the defendant from liability. 3 LOSS, SECURITIES REGULATIONS 1456 (2d ed. 1961). The *Cady Roberts* case implies the contrary: It is because no one had *received* the information that the respondent had the duty to forego the transaction until it was received. The Commission hints that perhaps the respondent did not have the duty to disclose, since that duty was imposed on the corporation and they were trying to disclose. Even if he had no duty to

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or sellers who were not already shareholders since there it was even more difficult to find a fiduciary relationship between the parties, nor did it extend to transactions on the security exchange.[24] Until *Cady Roberts,* the courts and even the Commission were reluctant to extend the application of the act to transactions on the exchange. Some common law cases expressing disapproval of unethical conduct in the securities market announced an intention to promote and to enforce higher ethical standards, but their good intentions were defeated by the rigid limitations of the common law remedies.[25] The law was at least moving toward the conclusion that full disclosure of all material facts must be made whenever elementary fair conduct requires it.[26]

The Securities and Exchange Acts of 1933 and 1934 were designed to correct the specific deficiencies in the common law doctrine of fraud[27] as applied to transactions in securi-

disclose he had an independent duty to refrain from dealing until those whose duty it was to disclose had fulfilled their obligations.

24. The theory was that there was no direct communication between the buyer and seller so no disclosure was appropriate. The nature of the market is impersonal and, therefore, each person determines for himself what course of action he should take without influence from any other person. In Perry v. Pearson, 135 Ill. 218, 25 N. E. 636 (1890), the court suggested that dealing at arm's length avoids any question of trust relation between the parties requiring disclosure of any facts bearing on the value of the stock. And similarly, in Sullivan v. Pierce, 125 Fed. 104 (5th Cir. 1903), although the court found a confidential relationship between the parties and a justifiable right to rely on the representations made as to the value of the stock the action failed because the parties had dealt at arm's length and thus the sale could not have been made in reliance upon the buyer's statements.

25. Goodwin v. Agassiz, 283 Mass. 358, 186 N. E. 659 (1933). The court said insiders ". . . cannot be allowed to indulge with impunity in practices which do violence to prevailing standards of upright businessmen." at 363. See also Oliver v. Oliver, *supra*, n. 17. Cary, *Corporate Standards and Legal Ethics*, 50 CAL. L. REV. 408 (1962); Comment, 32 MICH. L. REV. 678 (1934).

26. See PROSSER, TORTS 535; also Keeton, *Fraud-Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 31-40 (1936). Equity courts tended to be more liberal in imposing a duty to disclose because their emphasis was on preventing a defendant from obtaining an unfair advantage. Law courts, however, had to be more strict because a deceit action required the defendant to compensate the plaintiff for any loss he might have sustained. It has been suggested that equity courts and later the Securities Exchange Acts concentrate on the defendant's dereliction of duty rather than on a plaintiff's recovery of profits. Leech, *Transaction in Corporate Control*, 104 U. PA. L. REV. 725 (1956). The SEC seems to aim at preventing damage by promoting an atmosphere where free investment judgment may be relied on rather than adding more remedies to offer relief to those who have already been injured.

27. The term fraud as used in the Act was not meant to be limited to common law concepts but was intended to include ". . . all deceitful practices contrary to the plain rules of common honesty." Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 577 (1948), citing People v. Fed-

ties. The anti-fraud provisions are broad remedial provisions aimed at fraudulent security transactions which harm the investor and create a threat to the economic prosperity of the nation. While the common law stresses failure to disclose and provides remedies to a limited group, the federal law places emphasis on the positive aspects of disclosure and compels disclosure to the public generally. The anti-fraud provisions,[28] especially Rule 10b-5, provide a broad framework within which the courts and the Securities Exchange Commission may prohibit any practice or device which they might deem unfair.

Until *Cady Roberts,* the courts and even the Commission unjustifiably restricted the application of Rule 10b-5 to include only those insiders as defined by 16b (officers, directors, and 10% controlling shareholders).[29] Because of 16b's extensive limitation on the activities of corporate insiders when dealing in securities of their corporation, it seems that Rule 10b-5 was not meant to be merely another vehicle for

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erated Radio Corp., 244 N. Y. 33, 38, 154 N. E. 655, 657-58 (1926). See also Ellis v. Carter, 291 F. 2d 270 (9th Cir. 1961); Hooper v. Mountain Sec. Corp., 282 F. 2d 195 (5th Cir. 1960); Norris & Hirshberg, Inc., v. SEC. 177 F. 2d 228 (C. A. D. C. 1949); Charles Hughes & Co. v. SEC, 139 F. 2d 434 (2d Cir. 1943), *cert. denied* 321 U. S. 786, 88 L. Ed. 1077 (1944). Cases used the common law standards for imposing liability in applying the Rule, but applied the Rule more broadly than the common law.

28. Section 10 provides in pertinent part: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange—

(1) To employ any device, scheme or artifice to defraud.

(2) To make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

29. This definition is embodied in §16 which defines corporate insiders as officers, directors and "every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security. . . ." Securities Exchange Act of 1934 §16(a), 48 Stat. §96, 15 U. S. C. §78p (a) (1934).

protecting shareholders against abuses in that area, but was intended to have a broader scope and more far reaching effect.

Even at common law the duty of disclosure is imposed on officers and directors and, most recently, controlling shareholders, because of their relationship with the corporation. This duty runs from the corporate insiders to the corporation and from the corporation to the other shareholders by virtue of their relationship with the company. In *Cady Roberts* the duty stemmed not from the relationship with the corporation but rather from possession of knowledge of the corporation's activities. The duty to deal fairly runs not to the corporation but to the public directly. The fiduciary duty imposed on officers, directors, or controlling shareholders because of their relationship with the corporation arises out of other duties and considerations such as the duty of loyalty, involving self-dealing, and agency principles, involving the agent's dealings with his principal. The respondent in *Cady Roberts* did not have a relationship with the corporation and the corresponding duties and loyalties to the corporation, nor did he attain such a relationship with the acquisition of corporate information. The Commission superficially predicates the decision, at least in part, upon the existence of an imputed corporate insider relation since the director who gave the information was also an associate of the brokerage firm. The imputation concept has been applied in cases where a broker has purchased on behalf of an insider and has knowledge of inside information or information to impose the same duty of disclosure on the broker as that of the insider himself.[30] It has been traditionally held, however, that persons knowingly joining with a fiduciary in a transaction constituting a breach of duty or scheme to defraud are liable to the same extent as the one who breaches his fiduciary duty.[31] The requirement of "knowingly" means more than investing one's own funds on a tip received from a director.[32]

The establishment of a corporate insider relationship through the means of the director-associate was superficial

30. Fry v. Schumaker, 83 F. Supp. 376 (E. D. Pa. 1947); Hughes & Treat, 22 S. E. C. 623 (1946); M. S. Wien & Co., 23 S. E. C. 735 (1946).
31. Jackson v. Smith, 254 U. S. 586, 65 L. Ed. 418 (1921); Irving Trust Co. v. Deutsch, 73 F. 2d 721 (2d Cir. 1934); Ward LaFrance Truck Corp., 13 S. E. C. 373 (1943); Black v. Simpson, 94 S. C. 312, 77 S E. 1023 (1913); White v. Texas Co., 59 Utah 180, 202 Pac. 826 (1921).
32. Manufacturers' Trust Co. v. Butler, 338 U. S. 304, 94 L. Ed. 107 (1949); *In re* Carlton Crescent, Inc., 173 F. 2d 944 (2d Cir. 1949).

and unnecessary under the language of the Act. The essential question of liability on the open market was still open. If the director had been liable on the open market then the broker could have been liable in his own right on the same principle. The cases cited by the Commission as analogous fall short as authority for the imputed relationship here because those cases dealt with situations where the broker was held on breach of duty to disclose that he was an agent for an insider transacting for his own benefit. In the instant case there was no scheme between the broker and the director, and the broker received no profit other than ordinary commission.[33] Thus it would seem that the respondent was held to a duty to disclose, not because of his relationship with the director giving rise to an imputed corporate insider status, but as an insider in his own right because he had possession of information not publically available and which should have been public if the transaction were to be conducted honestly.[34] Since the aim of Rule 10b-5 is not to protect the corporation from loss[35] or to protect the individual shareholder as much as it is to censure dealings which are unfair to the public generally, there is no reason to base a duty to the public on a duty to the corporation.

The prohibitions of the Rule extend to "any person" in connection with the purchase or sale of securities regardless of his relationship with the corporation or his duties toward it.

33. It might be argued that he received the additional good will of those clients for whom he made the profit but his would indeed be a thin ground on which to base liability. The broker did argue that he acted only out of duty to his clients but the Commission rejected this contention saying that clients may not expect a broker to pursue their interests by unfair methods which constitute violations of the Act. The fact that civil liability might be denied the private litigant on these facts does not absolve the broker from responsibility for fraudulent conduct nor does it make disciplinary action unreasonable.

34. Query: Would the broker have been liable if he acted upon non-public information received from one with whom he had no business relationship? Tipees have been held liable if they knew or had reason to know that the information was given as a breach of trust. Strong v. Repide, 213 U. S. 419, 53 L. Ed. 853 (1909); *but see, In re* Carlton Crescent, Inc., 175 F. 2d 944 (2d Cir. 1949). Tipee liability has been implied from RESTATEMENT, TRUSTS §201(2). For a general discussion of this topic see 3 LOSS, SECURITIES REGULATIONS, 1451; Note, *Application of SEC Rule X-10b-5 to Prevent Non-Disclosure in the Sale of Corporate Securities*, 39 CALIF. L. REV. 429 (1951).

35. See Brophy v. Cities Service, 31 Del. Ch. 241, 70 A. 2d 5 (1949), where it was held that it was necessary to show that the corporation had been damaged; a sufficient cause of action was stated if there had been a breach of confidential relation of an employee. "Public policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit, regardless of whether the employer suffers too." See also 3 SCOTT TRUSTS §505.1 (1939).

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A violation of duty to the corporation may also be a violation of the Rule, but to violate the Rule there is no requisite that there be a violation of duty to the corporation. The Commission in *Cady Roberts* interprets the Rule as imposing an affirmative duty to disclose on "any person," including, but not limited to traditional 16b corporate insiders who, in the purchase or sale of securities, pursues a course of conduct which would operate as a fraud or deceit on "any person."[36]

Having gotten around the corporate insider relationship problem through broad interpretation of the words "any person," the Commission turned to the question of whether complete non-disclosure is a course of conduct or practice operating as a fraud and, if so, whether the Rule extends to impose liability for complete non-disclosure in a transaction on the open market. In order to establish a common law cause of action for fraud or deceit, specific elements must be proved including a material misrepresentation or misstatement of a material fact which is the proximate cause of injury, intent on the part of the perpetrator,[37] and justifiable reliance by the injured party. Under Rule 10b-5 all that need be shown is that in connection with the purchase or sale of securities there was (1) a misstatement, material misrepresentation or half truth, or a practice or course of conduct which would operate as a fraud or deceit on anyone and (2) use of the mails or some facility of interstate commerce. As has been shown there is no liability for complete non-disclosure at common law unless "the one party to a transaction 'by concealment or other action intentionally prevents the other from acquiring material information' or the one party is under a duty to the other to exercise reasonable care to disclose the

36. Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (2d Cir. 1952), limited "any person" to only buyers and sellers and refused to allow the Rule to be invoked by one not a buyer or seller. *Cady Roberts,* by overthrowing the restrictions on "any person" in the first clause of the Rule has paved the way for extending "any person" beyond buyers and sellers.

37. Intent may have been supplanted in the act by the concept of "willful." The most harsh sanctions are limited to conduct that is willful. However, willful does not mean that the party must be aware of the fact that he is violating the law. Knowledge of the legal consequences of an act is unimportant. It is necessary only that he was fully aware of all he was doing and was doing it voluntarily. Charles E. Bayley, 35 S. E. C. 33 (1953); Henry Leach, 24 S. E. C. 237 (1946); Thompson Ross Sec. Co., 6 S. E. C. 1111 (1940). See also 3 LOSS, SECURITIES REGULATIONS 1309-10 (2d ed. 1961). In *Cady Roberts* the Commission uses "willful" in the sense that the broker knew what he was doing. At 34-6668.

matter in question 'because of a fiduciary or other similar relation of trust or confidence between them.' "[38]

Under the Security Acts if the requirements of a common law action of fraud or deceit are not met but the situation is one which particularly deserved remedy on equitable principles, the courts turned to the failure to disclose and invoked the sanctions of Rule 10b-5. Thus the courts have applied 10b-5 as a catch-all provision to reach equitable results. However, none of the cases relied on by the Commission were decided solely on the basis of complete non-disclosure.[39] Those cases relied on as being ones where a violation of the anti-fraud provisions was found for mere failure to disclose were limited to situations in which insiders (16b definition) or the corporation itself had failed to disclose material facts when acquiring securities from the shareholders of the corporation.[40] The Commission relied on the *Speed* and *Kardon* cases without indicating the fact that failure to disclose was coupled with other breaches of duty on the corporate level and with violations of the other provisions of the Rule. Clause (2) of Section 17 and Rule 10b-5 do not by their terms cover complete non-disclosure. The Commission held that the respondent "at least" violated clause (3) of the Rule which makes it unlawful to engage in any transaction or course of business "which would operate as a fraud or deceit on any person." Thus in *Cady Roberts,* the Commission holds that fraud is *any* practice, including complete non-disclosure, which is unfair as determined by good business ethics.

The broad interpretation of Rule 10b-5, though justified by the language of the act and the Rule itself, is without

38. 3 LOSS, SECURITIES REGULATIONS 1434 (2d ed. 1961), citing RESTATEMENT, TORTS §550, §551(2)(a).

39. Several cases involved non-disclosure and §3 but each of the decisions involved half-truths which provided an alternative basis for liability. Ward LaFrance Truck Corp., 174 F. 2d 969 (C. A. D. C. 1949); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Fry v. Schumaker, 83 F. Supp. 476 (E. D. Pa. 1947); Kardon v. National Gypsum Co., 73 F. Supp. 789 (E. D. Pa. 1947); William I. Hay, 19 S. E. C. 397 (1945).

40. Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), where failure to disclose the future sale of assets when purchasing minority shareholders' stock was held to be a violation of all three provisions of the Rule. Kardon v. National Gypsum Co., 73 F. Supp. 789 (E. D. Pa. 1947), in which failure of controlling shareholders to disclose details of agreement to sell assets of closely-held corporation was held to be a violation of Rule 10b-5.

judicial or administrative precedent.[41] By virtue of its administrative and quasi-judicial authority the Commission has the power to render its own interpretive decisions. Thus it may apply its own standards to cases specifically subject to its jurisdiction without being bound by the carefully delineated safeguards of the courts. The dichotomy between the separate approaches is based on the difference in function between the two bodies. The courts must interpret the Rule in order to adjust and settle conflicting rights between parties. Subjective standards of proper conduct would be entirely inadequate. In a court of law there is constantly the question of damages and the valuation to be put on intangible rights and losses (*e.g.*, pain, suffering, consortium). Objective standards have been applied in law courts because it is thought they render the administration of law consistent.[42] The Commission, on the other hand, does not primarily settle disputes between parties; it regulates the activities of a particular group of persons according to the standards laid down pursuant to a policy of upholding, promoting, and improving the integrity of the securities market. The standards, as applied in this case, were acknowledged to be the subjective standards of fairness and honesty. The decision leaves security dealers to a subjective determination as to whether a course of conduct is proper or improper. This is consistent with the act in which Congress left the determination of the standards of fraud up to the Commission. Thus in *Cady Roberts*, the Commission finally has an opportunity to administer the spirit of the act, which is to expand the concept of fraud so that the investing public may rely without detriment on the honesty and integrity of the security market and those who deal therein. Any injury received will be due to the investor's own faulty judgment or the capriciousness of fate rather than the result of abuse by one made shrewd by failing to disclose information he obtained which ought to have been made available to all those concerned.[43] By

41. The Commission has always sought a broad interpretation of Rule 10b-5. The briefs submitted by the Commission as amicus curiae bear this out.

42. In *Cady Roberts*, the Commission adopts a policy of being consistently subjective, thereby supplying the element of consistency.

43. "That the ignorant may lose out to the shrewd is due largely to the fact that God did not create all men equal, a situation for which Congress and the Securities Acts have not yet supplied a remedy." Note, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L. J. 1120, 1156 (1950).

using the subjective standard of fair dealing rather than the common law standards of fraud liability, the Commission was merely bringing the federal rules up to what the National Association of Securities Dealers and the New York Stock Exchange had already provided for in their fair practice rules whose purpose it is ". . . to cope with those methods of doing business which while technically outside the area of definite illegality, are nevertheless unfair both to customers and to decent competition, and seriously damaging to the mechanism of the free and open market."[44]

The case has been criticized[45] on the ground that a subjective standard is too vague. A broker with important contacts will have knowledge about the corporation that is not generally available to the public. These critics raise the question whether a broker must disclose all confidential information obtained in the normal course of investigation or in the alternative refrain from executing transactions upon receipt thereof. *Cady Roberts* seems to be inapplicable in this area, but the critics say it is too difficult to draw the line between information which may be acted upon and that which may not. These critics cast doubt on the propriety of subjecting persons to liability where no affirmative statements are made and further assert that the subjective standard is not an adequate standard. They argue that Section 11 of the Securities Act which deals with liability in connection with registration statements includes a non-disclosure prohibition. This provision is not in Section 17(a) or Rule 10b-5. The standards governing Section 11 are carefully set forth in Schedules A and B to the Securities Acts and in forms adopted by the Commission pursuant to the authority granted it. Thus, there is an established guide, not only for the purpose of planning, but also for judging thereafter. In contrast, no standards are set forth in 17(a) or Rule 10b-5 thereby possibly indicating a Congressional intention to exclude complete non-disclosure from the concept of fraud. SEC Chairman Cary, in his article, *Corporate Standards and Legal Ethics*,[46] says that if the use

44. National Association of Securities Dealers, Rules of Fair Practice E-131 (1958). See also Wall Street Journal, November 19, 1962, "Big Board Censures Member for Close Tie Between Own Trade Firm's Stock Letter."

45. Daum & Phillips, *The Implications of Cady Roberts*, 17 BUS. LAW. 939 (1962). See also 36 ST. JOHN'S L. REV. 378 (1962); 71 YALE L. J. 736 (1962); LOSS, SECURITIES REGULATIONS (Supp. 1962 at 4-6).

46. 50 CALIF. L. REV. 408 (1962).

of information is governed by whether the use would be consistent with ethical standards of fair business dealing, there will be no difficulty in determining whether disclosure will be required under the act. The duty to disclose attaches only where one has possession of information which, if used without disclosure to the other party, would be unfair. If the party in possession does not wish to disclose, or if it is inexpedient to do so due to corporate duties or the complexities of the exchange, then the alternative duty is to refrain from dealing. The standards of honesty and business integrity, while often not the most profitable guides for the moment, are not arbitrary, nor are they vague.

The proper function of the Securities Exchange Commission is to raise the standards of the securities market and this is most effectively done by raising the standards of those who deal therein. *Cady Roberts* is the most far reaching example of this philosophy. While "law in its sanctions is not co-extensive with morality"[47] is still a prevailing concept, "the law of today embodies the morality of yesterday and should be anticipated."[48] Responsibility predicated on unfairness was said to deter men of principle from accepting managerial posts.[49] The Securities Acts were aimed at shattering the prevailing idea that it is perfectly reasonable to use inside information to the disadvantage of another who does not have such knowledge as long as it does not violate objective legal standards. *Cady Roberts* might be said to be aimed at legal advisers to warn them of the closing gap between law and ethics; of what may, and probably will, become the law. "The law . . . represents standards presently imposed by a governmental or quasi-governmental authority. Ethical action . . . is that which is motivated by a self-imposed standard rather than compelled by law. The wise counselor will assess the need for ethical restraint because he views it as potential legal restraint. One might describe this as becoming law."[50] *Cady Roberts* represents the extent to which the Commission is willing to depart from legal rules and standards to regulate the activities of the securities market and is the most extreme example of the theory that complete disclosure is

47. Goodwin v. Agassiz, 283 Mass. 358, 186 N. E. 659 (1933).
48. Cary, *Corporate Standards and Legal Ethics*, 50 CALIF. L. REV. 408, 416 (1962).
49. Goodwin v. Agassiz, *supra* note 47.
50. Cary, *supra* note 48.

the principle underlying both legal rules and ethical standards in the securities market. It is a step toward refinement of a sense of ethics whose basis is the belief that, in the long run, good ethics is good business.

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